

## NATIONAL FORECAST DESCRIPTION

### **The Forecast Period is the Second Quarter of 2007 through the Fourth Quarter of 2010**

The U.S. economy stalled in the first quarter of this year. Real GDP, the broadest measure of economic performance, eked out just 0.7% growth at the beginning of this year. Growth was held in check by a combination of the faltering housing market, weak net exports, and the reduction in private inventories. Together these factors erased nearly three percentage points from first quarter real GDP growth. This disappointing showing has divided economists into two major camps. The pessimistic camp believes the economy's first quarter performance was just a taste of things to come, and the economy will remain in the doldrums for a while. The other camp views the first quarter's slowdown as temporary and the bottom of the current economic cycle. It believes real GDP growth will quickly bounce back from its trough and soon expand more rapidly.

Economic pessimists offer several reasons for their bleak outlook. These include financial volatility, the subprime meltdown, rising oil and gasoline prices, high consumer debt levels, the current-account deficit, and the risk that central banks will dump dollar assets. While these risks do exist, their impacts may be overstated. First, the increased market volatility since late February has led some to predict an impending credit crunch. But major stock indexes have bounced back recently and are near historic highs. Furthermore, 10-year bond yields have fallen from their recent peaks and are still at historically low levels. Second, subprime mortgage problems seem to be contained. The prime mortgage market remains healthy due to the still-favorable financial environment and abundance of liquidity available in the global economy. Third, the threat to consumer spending by rising oil and gasoline prices will be dampened by the positive impact of continuing job growth and decent real wage increases. Fourth, consumer debt, while high, is not a serious constraint on spending. Household wealth provides a cushion because it is high, both in absolute terms and relative to take-home pay. Fifth, the current account deficit is smaller than had been thought. For example, the 2006 deficit was lowered from \$857 billion to \$811 billion. While the deficit still exists, it is not as big a problem as was previously believed. Sixth, some analysts fear foreign central banks will dump their dollar holdings, which would lead to a spike in long-term interest rates. This action seems unlikely. Despite constant hand wringing, the share of dollar assets held as reserves by central banks has been stable for the last three years. Most importantly, central banks are not interested in triggering a sharp rise in U.S. interest rates and a sharp drop in the dollar.

Given these reasons, the current Global Insight macroeconomic forecast treats the first quarter slump as an anomaly. Real GDP is projected to increase at a 3.2% annual pace in the second quarter of 2007. In this scenario, inventories and real net exports go from being a drag on the economy in the first quarter to a source of growth, contributing 1.6 percentage points to real GDP growth in the second quarter. Housing remains a drag, subtracting 0.7 percentage point from real output growth.

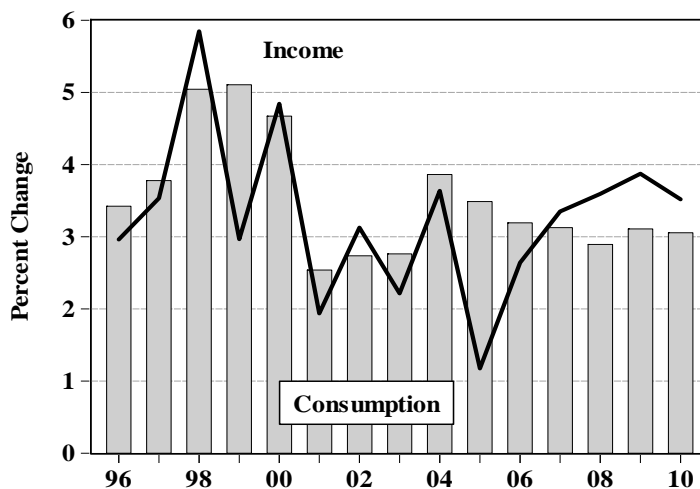
The quick turnaround from the first quarter slump does not guarantee robust future growth. In fact, although the economy is forecast to expand both this year and next, its projected growth is below its potential. Real GDP growth is anticipated to breach 3.0% in 2009 then slip back to 2.8% in 2010. While the economy is not expected to perform as strongly as it did in recent years, it should out perform the predictions of the pessimistic camp.

## SELECTED NATIONAL ECONOMIC INDICATORS

**Consumer Spending:** Real consumer spending should remain fairly insulated from the impacts of the retreating housing sector. This prediction may appear inconsistent given spending's recent behavior. Real consumer spending slowed to a 1.4% annual pace in the second quarter of this year, after growing over 4.0% in the two preceding quarters. However, this decline cannot be blamed on housing. Instead, soaring gasoline prices are the culprit. Every 10-cent rise in the retail price of gasoline costs consumers \$12 billion per year. Thus, the surge in pump prices from the first to second quarter of this year drained 0.76% from personal income. The higher inflation prompted consumers to cut back purchases of energy, food, and vehicles. However, spending should improve as gasoline prices start to ease. Real spending will also benefit from rising real disposable personal income, an expanding job market, and improving household balance sheets. Propelled by rising real wages, inflation-adjusted disposable income advances about 3.6% annually over the forecast period, serving both as a fuel and upper limit for real spending growth. The healthy job market has two main impacts on spending. First, as already mentioned, it causes real wages to rise. Second, it pushes consumer confidence above 90 over the forecast period, which is an improvement from 87.3 in 2006. Consumers' moods should also be lifted by rising real household net worth. Riding the crest of the housing market tidal wave, household real net worth increased 5.4% from 2005 to 2006. It is expected to stall this year due largely to the anticipated decline in home prices. After this year's setback, real net worth is projected to increase through 2010 because of expanding financial assets. Having just seen the price of gasoline rise over 25% and the value of their nonfinancial assets whipsaw from 2006 to 2007, consumers are not likely to throw caution to the wind. A safe bet is spending should advance slightly slower than real disposable income over most of the forecast period. This new found frugality will lower the ratio of nonmortgage debt to personal disposable income from 25.2% in 2006 to 23.0% in 2010. Also, the restrained spending helps the U.S. savings rate return to positive territory in 2009 for the first time since 2004.

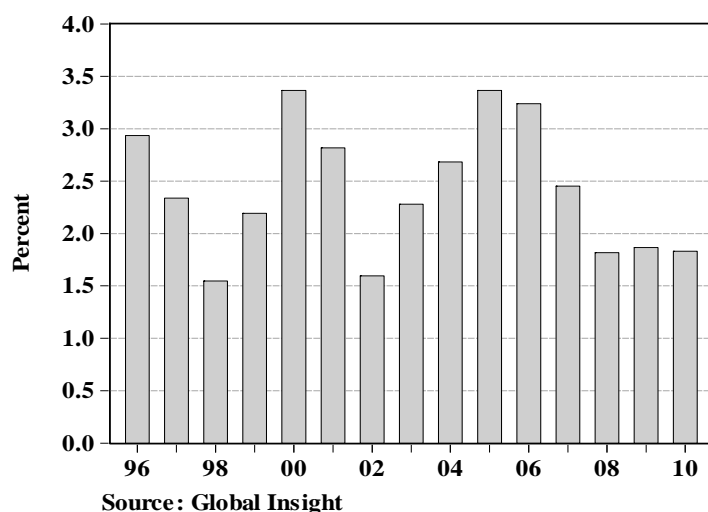
**Inflation:** The current inflation situation varies depending on whom you ask. Consumers will probably tell you inflation is too high. Their observation is validated by reports that show the overall or "headline" consumer price index jumped 0.7% in May 2007. This increase was the largest rise since September 2005, in the wake of Hurricane Katrina. Over the last three months energy prices have galloped at an amazing 71% annual pace. Consumers are reminded of this every time they fill their cars. The average retail price (including taxes) of gasoline increased from \$2.33 per gallon as recently as the last quarter of 2006 to an estimated \$3.06 per gallon in the second quarter of this year. Some of this change reflects seasonal factors. This is why on a year-over-year basis gasoline was up just 4.8%. However, some of the price increase can be blamed on inventory problems caused by the frustrating shortage of domestic refining capacity. Unfortunately, increasing refining capacity has been agonizingly slow. However, progress has been made, suggesting gasoline prices may have already peaked. Gasoline prices faded in June, averaging \$3.10 per gallon, which was down 2.7% from May. The price of gasoline hovered near \$3.00 per gallon in early July, which was 25 cents lower than the Memorial Day price.

### U.S. Real Consumption and Disposable Income Growth



Source: Global Insight

## Consumer Price Inflation

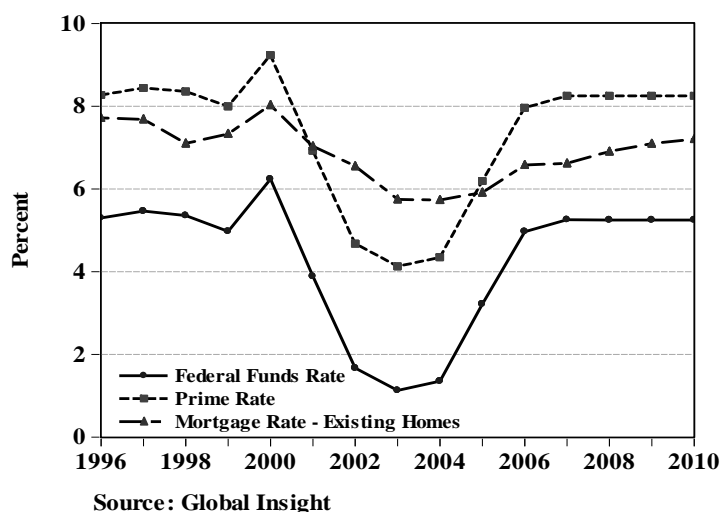


Unfortunately, after an initial drop from this year's high, further gasoline price declines will be stymied by rising oil prices. The West Texas Intermediate price of oil is expected to peak at \$66.00 per barrel in this year's third quarter, but remain above \$60.00 per barrel throughout the forecast period. After peaking in the second quarter of this year, the price of gasoline is expected to bounce between \$2.40 and \$2.80 per gallon over the forecast period. Overall consumer inflation is forecast to run at 2.5% this year then drop just below 2.0% in the remaining years of the forecast. The Federal Reserve's recent assessment of inflation is a bit more optimistic than the consumers' view. In its statement following its late June meeting the nation's central bank said, "Readings on

core inflation have improved modestly in recent months." Its opinion differs from consumers because the Federal Reserve focuses on the core inflation rate. Since this inflation rate does not include the influences of energy and food prices, it has not risen as fast as overall inflation; it has averaged about 2.0% during this year's first half. Core inflation is projected to be just over 2.0% over the forecast period.

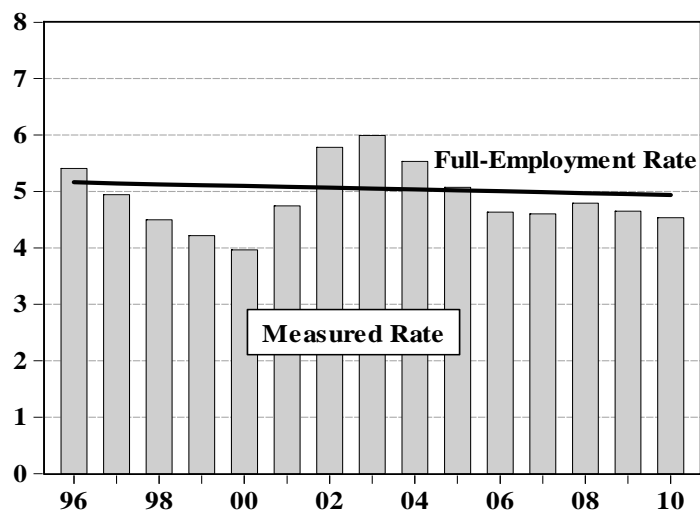
**Financial Markets:** On June 28<sup>th</sup>, the Federal Reserve once again passed on its chance to raise the federal funds rate. In the press statement following the Federal Reserve's meeting, it appears the Federal Reserve is a little more optimistic about future inflation. However, it has not declared inflation dead, either. The Federal Reserve warned that sustained moderation in inflationary pressures has yet to be convincingly demonstrated, and that the high rate of resource utilization has the potential to sustain these pressures. While upside risks to inflation remain the dominant concern, the Federal Reserve is expected to keep its policy options open. The bottom line is that the economy is muddling through the current mid-cycle slowdown. Housing is a drag on the economy, but consumption, business investment, and exports should keep it afloat. This situation will actually help make the Federal Reserve's job a little easier. For all practical purposes, this is about as close to an ideal situation for the Federal Reserve to gently squeeze inflation out of the system without putting the economy into a tailspin. Under these conditions, the Federal Reserve is assumed to keep rates steady for the foreseeable future.

## Selected U.S. Interest Rates



**Business Investment:** Nonresidential fixed investment will be an important cog in the nation's economic engine thanks to the improved spending on equipment and software. After eking out just 1.9% growth in 2007, equipment and software investment will recover nicely. After stumbling in the fourth quarter of 2006 and the first quarter of 2007, real equipment and software investment is forecast to find its legs in this year's second quarter and expand steadily over the forecast period. The jump in expenditures for information processing equipment includes a temporary kick in spending on computers and software related to the introduction of Microsoft's Vista operating system. Not all recent impacts were positive, however. Transportation equipment expenditures declined at the start of this year. This happened because companies accelerated their equipment purchases into 2006 before enactment of new EPA regulations. Real spending on nonresidential structures will enter 2007 with enough momentum to carry it at a 7.8% pace. This strength will help dampen the impact of soft equipment and software spending this year. Starting next year, the roles reverse. Spending on equipment and software should pick up speed while spending on structures flattens. Specifically, real spending on equipment and software advances 4.9% in 2008, 7.1% in 2009, and 4.6% in 2010. Spending on structures grows 2.2% in 2008, declines 1.2% in 2009, and grows 0.8% in 2010. Overall, nonresidential fixed investment is forecast to rise 4.1% in 2008, 4.5% in 2009, and 3.5% in 2010.

### U.S. Civilian Unemployment Rate



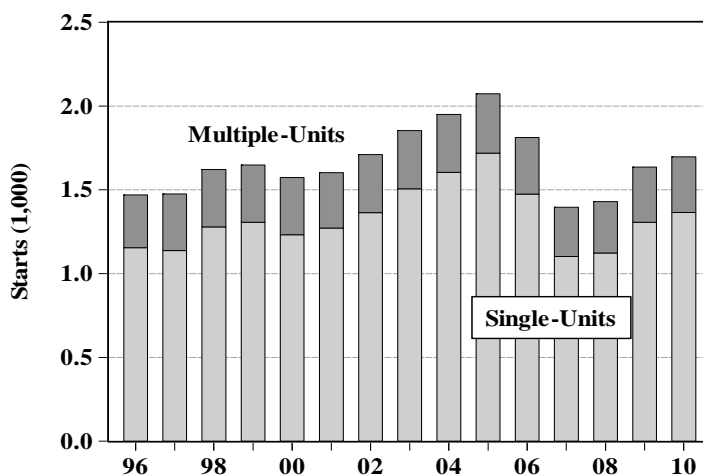
Source: Global Insight

**Employment:** Nonfarm employment growth is forecast to dip over the next few quarters, but pick up speed toward the latter years of the forecast. The U.S. Department of Labor reported nonfarm payrolls expanded by 132,000 jobs in June 2007, which was just under the 145,000 job year-to-date average. Most of the gains were in the nongoods sector, with the service sector enjoying continued job increases. Government employment increased by 40,000 jobs, with over two-thirds of the gain in state and local education. Not all sectors were winners, however. Retail employment, with the exception of food stores, sagged almost across the board. The manufacturing sector continued to shed jobs. Interestingly, construction payrolls rose by 12,000 jobs in June on the strength of

its nonresidential component. However, this increase should be viewed with caution. There is a massive potential for misclassification of construction jobs between the residential and nonresidential segments. It is also possible the Department of Labor procedures that try to predict the “births” and “deaths” of construction firms are producing overly optimistic results. “Off the books” workers are a wild card. If the “off the books” dimension was dominant, it should have produced a “reported” productivity miracle in construction during 2003-2005, but this is not supported by the productivity data for this period. The U.S. unemployment rate remained unchanged at 4.5% in June 2007, the same as it was in April and May. But after months at this level, the unemployment rate is expected to begin rising. Nonfarm employment gains are expected to average about 120,000 jobs per month until sometime next spring. Unfortunately, this is slower than labor-force growth, so the unemployment rate is projected to climb to 4.8% by next spring—its highest level since 2005. Nonfarm employment growth should accelerate beginning the second half of 2008, as the economy rebounds. This revival in payroll growth will return the unemployment rate to near current levels by 2010.

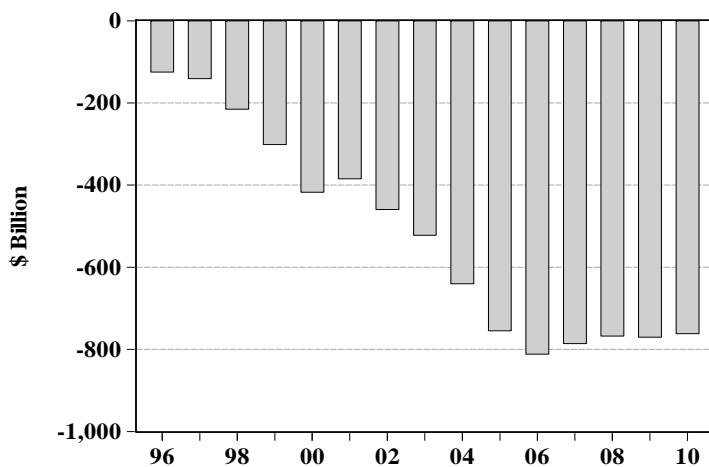
**Housing:** Recent measures suggest the U.S. housing sector is still in decline. The two most reliable indicators of the housing industry's health are existing home sales and single-family permit data. The former measures demand and the latter measures supply. Existing home sales suffered a disappointing drop in April 2007. Because of weak sales the supply of existing single-family homes rose from 7.2 months to 8.3 months, its highest reading since August 1992. In addition, sales of single-family houses in May 2007 were nearly 16% lower than in the previous May. At the current rate of sales there is a 7.1-month supply of homes available. Housing permits plunged in all regions of the country in May 2007 compared to May 2006, a sign that the subprime lending market was taking its toll. Two factors will be behind an eventual housing turnaround. They are falling housing prices and demographic demand. House prices are falling or showing slower gains nearly everywhere in the country. The current forecast calls for the median price of an existing home to drop 2.6% this year and 3.2% next year. New household formations, in addition to growing demand for second homes and replacement demand, are a constant source of demand for new housing. These three sources, which add about 1.5-1.7 million units to demand annually, should keep housing starts from falling too far. In the forecast, housing starts total 1.40 million units in 2007 and 1.43 million units in 2008, which is not enough to meet steady-state demand. As a result, the inventories of unsold homes should come down. The slowdown in housing starts causes residential investment to drop 16.1% in 2007, which trims 0.9 percentage points off real U.S. output growth. Eventually, falling home prices will stimulate demand and improve home sales. These increased sales should reduce the inventory overhang, which, in turn, will lead to growing housing starts. Specifically, after falling to 1.40 million units in 2007, U.S. housing starts are projected to reach 1.43 million units in 2008, 1.64 million units in 2009, and 1.70 million units in 2010.

## U.S. Housing Starts



Source: Global Insight

## U.S. Current Account Deficit



Source: Global Insight

**International:** The U.S. economy finds itself in the position of being one of the world's slowest growing economies. This is uncharted territory for the U.S. which usually has one of the world's fastest growing economies. For example, the national economy's 3.3% expansion last year was topped only by China, South America, Asia (except for Japan), and Mexico. The U.S. economy is expected to slow to 2.1% in 2007, which is even weaker than perennial bottom dweller Japan (2.8%). The U.S. economy should accelerate after this year, but it should still expand slower than overall world economic growth. The U.S. dollar is projected to continue sliding over the forecast period. The greenback will lose

almost 10% of its value versus the currency of its major trade partners and 4.5% against its other important trade partners. The combination of slower economic growth and the falling dollar will boost prospects for exports, which should help shrink the trade deficit. In addition, the trade balance also benefits from the drop in the price of oil later this year. As a result, net exports go from being a small drag on the economy, to a contributor to economic growth in 2007 and 2008. Specifically, the real net export deficit shrinks from \$618 billion in 2006 to \$542 billion in 2010. The U.S. current account trade deficit will hover between \$800 billion and \$750 billion over the next few years.

**Government:** The U.S. Treasury reported a \$27.5 billion surplus in June, up from a \$20.5 billion surplus in June 2006. Total revenues rose by 4.6%, propelled largely by a 12.2% jump in individual income tax receipts. Expenditures rose by 2.1%, as strong increases in Social Security and Medicare were partially offset by a sharp decline in Medicaid. This drop appears to be an anomaly, though, as fiscal year-to-date Medicaid spending was up 6.0%. For the fiscal year to date, the federal government incurred a deficit of \$121.0 billion, \$85.5 billion less than the shortfall in the comparable period of 2006. Revenues have risen 7.5%, whereas expenditures are up just 2.5%. This year will be a landmark year. The unified budget deficit is expected to fall to \$180 billion this year—its lowest level since 2002. After this year, the federal budget will begin to creep up, rising to \$230 billion by 2010.